RECENT DEVELOPMENTS IN OCCUPATIONAL PENSION PLAN ACCOUNTING

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1. This note highlights some of the recent developments relating to occupational[1] pension accounting, and in particular that, under IAS19 recommendations, unfunded pension benefits are to be recorded, as a general rule, as liabilities in the balance sheet of the sponsoring employer. The International Accounting Standards Board (IASB) clearly distinguishes two categories: defined contribution plans and defined benefits plans. In this paper, we focus only plans that are <u>not</u> defined contribution from the plan sponsor's (i.e. the employer's) perspective[2]. In defined contribution plans, the sponsor's obligation is clearly defined under the terms of the plan. In these plans, employers face no liabilities under the existing arrangement. The IASB, through the rule IAS 19[3], has determined that in these cases the employer's annual contribution under the terms of the occupational plan should be recognised as an expense. Of course, the terms of the plan may be revised, and employers may be required to, for example, increase their contribution to the plan. If after any modifications the new plan is still a defined contribution one, the same IAS 19 rule applies for the recognition of employer's expenses.

2. While defined contribution plans carry no liability for employers, they do not necessarily lay investment and biometric risks on the plan members. Occupational plans are sometimes administered by a third company, a life insurance company or a dedicated pension entity (who is often regulated as an insurance company), that may offer guarantees over returns or/and underwrite annuities[4]. Such schemes are

[1] According to the OECD pensions taxonomy, an occupational pension plan is linked to an employment relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups of employers (e.g. industry associations), professional and labour associations (e.g. trade unions). Generally, the plan sponsor is responsible for making contributions under the terms of occupational pension plans, but employees may be also required to contribute. Sponsors may also have administrative or oversight responsibilities for these plans.

[2] The OEC D Working Party on Private Pensions recently approved a classification of occupational plans into defined benefit and defined contribution that is consistent with that of IASB. Sometimes, in the pensions literature, the terms defined benefit and defined contribution are defined taking into account the extent to which the contribution as opposed to the benefit formula is fixed under the arrangement, rather than the nature of the employer's obligation (as in the OECD/IASB definition).

[3] The International Accounting Standards Board approved IAS 19 in May 1999 and has since revised it in two occasions, in 2000 and in 2002. IAS 19 prescribes the accounting and disclosure rules with respect to employers' benefits, in particular "post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care". Post employment benefits plans are classified as either defined contribution plans or defined benefit plans.

[4] The new EU Directive on Institutions for Occupational Pension Provision actually requires that pension entities that underwrite any investment or biometric risk should be subject to the Third Life Insurance Directive.

prevalent in some Nordic countries, such as Denmark and Iceland. The accounting treatment of the employer, however, is that of a defined contribution plan under the OECD/IASB definition.

Identifying employers' liabilities and assets in defined benefit plans

3. In occupational plans other than defined contribution plans, which both the IASB and the OECD pensions taxonomy refer to as defined benefit, employers bear contingent liabilities for any benefit or return promises made. These promises may be liable to revision in accordance with the plan rules, but the legal provisions typically impose restrictions on downwards revisions. In particular, vested accrued benefits are usually protected from arbitrary reductions by so-called "anti cut-back rules". Employers may also terminate pension plans in some countries (e.g. other United States), but the tax authorities impose such high fines that most employers prefer to transform the plans (and shift some risks to members in the process) rather than terminate them. In other countries, such as the United Kingdom, the plan rules often do not permit the termination of the plan. Hence, in general, the employer has what the IASB calls a "constructive" even if not always a "legal" obligation to continue sponsoring defined benefit plans. Indeed, most plans are only terminated as a result of bankruptcy of the plan sponsor.

4. Another difficulty in identifying the employer's liabilities is that the plan may be a contributory one (i.e. plan members are also required to contribute). The plan rules may foresee adjustments in plan members' contributions as well as the employer's in order. The precise sharing of the contribution burden may not always be clearly stipulated in the plan documents. As a consequence, the employer's liability cannot be pinned down precisely. This situation occurs in some OECD countries such as the Netherlands and Switzerland. However, most occupational defined benefit plans in OECD countries are non-contributory. Therefore, this identification problem does not arise.

5. Employer's liabilities can be divided into two main groups: those where the plan sponsor offers guarantees against investment and longevity risk and those where the plan sponsor only offers guarantees against investment risk. It is therefore possible to classify defined benefit plans according to the extent of risk that plan sponsors bear. Plan sponsors bear most risk in final salary plans, where they bear both investment and longevity risk before and after retirement. Moreover, these plans offer implicitly a guaranteed rate of return over the worker's career (the rate of growth of the worker's salary) that is not known until retirement. Career-average salary plans expose employers to less risk, because the value of the benefit pertaining to past service is already determined. On the other hand, employers are as exposed to longevity risk as in final-salary plans.

6. In some OECD countries, however, some aspects of the benefit formula are not guaranteed and are adjusted depending on the investment performance of the pension fund. In the Netherlands, for example, the extent of benefit indexation is determined by the pension fund's board on the basis of the fund's solvency, rather than by the plan sponsor when the plan is set up. Benefit indexation, therefore, has a defined contribution nature from the employers' perspective. The investment risk pertaining to indexation is borne by the plan members. Furthermore, in some plans, such as the ABP, which serves 1 million people working in government and education across the Netherlands, the state's contribution as plan sponsor is defined in terms of contributions to the plan, rather than benefits. Plan members are called to increase their contributions when the solvency of the pension plan deteriorates. Hence, the ABP plan is a defined contribution one from the plan sponsor's perspective.

7. Employers bear only investment risk in plans that offer only a guaranteed rate of return on contributions. To the extent that these guarantees fall at least partly on the employer, these plans are defined benefit according to the OECD (and IASB) taxonomy. However, countries differ in the extent to which these promises can be adjusted and the burden for meeting them shared with the plan members:

- In Switzerland, occupational pension plans must offer a guaranteed rate of return of 3.25 percent when calculating a workers' accumulated fund when they switch plans and at retirement. The annuity rate, however, is only determined at the time of retirement. The employers are by law responsible for this engagement, but plan members' contributions may also be adjusted. Moreover, the guarantee is not legally binding. In fact, as a result of the recent market downturn, the return was lowered from 4% and the social partners are considering lowering it further.

- In the cash-balance plans in the United States, employers contribute a set amount of salary for each worker every year to the pension fund and keep individual accounts for each worker which are credited some guaranteed annual return – typically the yield on 30-year treasuries. Cash-balance plans are treated as defined benefit plans and are hence insured by the Pension Benefit Guarantee Corporation.

- Under the new industry-wide occupational pension plans in Belgium, employers are legally responsible for meeting an annual minimum return of 3.75 percent on employees' contributions, whether the plan is defined contribution or defined benefit[5]. For defined contribution plans, the minimum return on employer's contributions is 3.25 percent. The employers that sponsor the plan are by law responsible for this engagement.

8. Companies that sponsor defined benefit pension plans are faced with two related problems: those related to the presence of promises and guarantees and those related to adverse demographic and economic developments. These factors, together with investment and funding regulations, condition solvency and risk management in occupational pension plans, whether they are funded internally or through a pension fund.

9. Increasing life expectancy represents a growing cost for final salary and career average salary plans. The first is the traditional type of plan found in most OECD countries. Population ageing, however, is a long term problem, and one that can be appropriately addressed by raising the retirement age of these plans. Unfortunately, this is easier said than done. In most OECD countries, there is a strong popular resistance to delaying retirement. Unsurprisingly, therefore, the growing type of occupational plan is a defined contribution one or a defined benefit one where only investment risks are insured against. Through such arrangements, employers can shift the burden of longer retirement periods to their workers without having to change the retirement age.

10. Investment risk, on the other hand, is very much a short term problem and one that affects all employers that sponsor defined benefit plans, regardless of their type. Three years of stock market declines have dented severely the funding level of defined benefit plans in most OECD countries. In addition, falls in discount rates have raised the level of pension liabilities valued using market principles. The fall in funding levels has been particularly dramatic in countries where pension funds invest heavily in equities, such as Canada, the Netherlands, Switzerland, the United Kingdom and the United States. According to one risk rating firm, funding levels are now well below 100 percent in some occupational plans in these countries.

11. The reaction to these funding worries, nonetheless, has not been symmetric across OECD countries. Unfunded occupational pension promises and guarantees have created most strain for plan sponsors when they are the sole or main contributors to the plan and when accrued benefits are protected

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5 The terms defined contribution and defined benefit are used in relation to the pension plan's features. Defined benefit plans, from this perspective, are those where benefits are predefined in relation to the worker's salary and length of employment. From the perspective of the sponsoring employer (the OECD/IASB definition), both types of plans are defined benefit.

by law, as is the case in the United States and to a lesser extent the United Kingdom[6]. The consequences of unfunded pension obligations are less drastic for companies in countries where these obligations can be redefined in situations of financial stress (as in Switzerland, where the minimum rate of return was recently lowered from 4 percent to 3.25 percent) or where plan members can be called to make additional contributions (as in the Netherlands).

12. Typically, employers collateralise these contingent liabilities by setting up autonomous pension funds. Hence, at any time, the plan sponsor's actual liability is the difference between the plan's liabilities that are his responsibility and the assets accumulated in the pension fund. In principle, if the plan's assets exceed its liabilities, the plan sponsor may claim ownership over the excess. However, the assets of the autonomous pension fund are legally separate from the plan sponsor. At best, the sponsor can derive benefit from funding excesses (created when plan assets exceed liabilities) through its rights to (i) refunds and reductions in future contributions, (ii) fund increased benefits to current and future employees, and (iii) not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

13. In many OECD countries, however, employers do not have rights to refunds and in case of plan termination, any funding excess must normally be shared among the plan members/beneficiaries. One exception is the United States, where in case of plan termination, excess funds can revert to the sponsor, but only after payment of a hefty 50 percent excise tax. Moreover, tax authorities usually impose maximum funding rules that limit the extent to which any funding excess can be created in the first place. Hence, in general, employers are responsible for most if not all of the plan's liabilities but have few if any right to the plan's assets in the case of funding excesses (and none, of course, in the case of funding shortfalls).

14. A handful OECD countries still permit the use of non-autonomous pension funds for funding defined benefit plans. The most common type of non-autonomous fund is the so-called book reserve method, as used in Austria, Germany, and Sweden. Under this method, the plan's assets appear as reserves in the sponsoring company's balance sheet.

Valuing employers' liabilities and assets in defined benefit plans: IAS 19

15. Accounting standards for occupational pension plans vary significantly across OECD countries. In fact, if they have anything in common it is the fact that employers did not disclose the net position of the plan (surplus/deficit) in their balance sheet (sometimes only in the footnotes to the annual report). This situation will change with the implementation of new international accounting standards.

16. IAS 19 as currently drafted proposes a common framework. The rule's most noteworthy aspects are the following:

- In general, unfunded pension benefits in defined benefit plans should be recorded as a pension liability in the employer's balance sheet (see amortisation rules below).

- The projected unit credit method should be used for valuing pension liabilities. This method involves the projection of salaries to the estimated time of realisation of the insured event (retirement, disability, death, departure from company, etc)

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6 In the United Kingdom, employers can at least partly shift some of the burden to employees by requiring increased contributions from them to the pension plan. They can also terminate a pension plan at their will. This flexibility explains not only why so many UK defined benefit plans have been closed to new entrants, but also why so many UK companies have committed themselves to maintaining their defined benefit schemes, despite heavy losses over the last few years.

- The discount rate to value liabilities should be based on high quality corporate bond yields at the balance sheet date.

- Indexation and other benefit increases should be taken into account to the extent that they are part of the formal or constructive terms of the plan.

- Pension plan assets should be valued at fair value. Discount cash flows should not be used if market values exist.

- Actuarial gains and losses (including investment) within a range of 10% of plan assets or obligations may not be reflected at all on the balance sheet. Actuarial gains and losses above/below this level can be amortised over the working life of employees.

- A pension plan surplus may be deemed as an asset of the sponsoring employer if the surplus might be refunded to the company or used to reduce future contributions

17. IASB standard IAS 19 is particularly relevant for European Union countries, because the European Council adopted a resolution in June 2002 which will require all listed companies based in the European Union to comply with this accounting standard in the preparation of their consolidated group accounts for years commencing on or after 1 January 2005.

18. Some European countries have already begun to adapt their accounting rules to comply with IAS 19. The United Kingdom recently introduced FRS17 which is largely consistent with IAS 19. The main difference is that FRS 17 requires that any actuarial and investment gains and losses are fully and immediately recognised on the company's balance sheet statement. IAS 19 may actually be reformed to follow FRS 17 practice. Indeed, in June 2002, the IASB tentatively agreed that actuarial gains and losses should be recognised immediately. i.e. that the 10 percent corridor and spreading options within IAS 19 should be removed. This decision, if implemented, would also prohibit the smoothing of actual returns. The effect of return smoothing is similar to that of the spreading option within IAS 19. Instead, IASB seems to be veering towards fair value without any smoothing or spreading options.

19. In the United States, existing accounting standards (FASB 87) are largely consistent with the current version of IAS 19. In particular, under FASB 87, companies can use an assumed rate of return on their investments for their year and can amortise any actual investment gains and losses over a period not longer than the estimated average remaining working lives of employees participating in the plan. The assumed rates of return were required to reflect historic investment performance of the types of assets in their pension fund, but U.S. accounting rules do not provide companies detailed instructions for picking each year's rate. The use of an assumed rate of return has helped companies smooth out the impact of investment risk on the company's financial performance. Throughout the 1990s, interest rate assumptions of over 8 percent were common. Since the bursting of the stock market bubble, however, most companies have continued to use such assumptions despite the fact that returns have been negative for the past three years.

20. IASB pension standards are likely to be even more daunting in countries such as Germany that still have pension schemes run on a book reserve method. German accounting rules permit pension obligations incurred prior to 1987 to be ignored entirely for balance sheet accrual purposes (they are disclosed only in the footnotes). Unfunded pension provisions incurred since then must be shown on the balance sheet of the sponsoring employer. These liabilities are often valued using a discount rate of not more than 6 percent (the rate prescribed under German tax law). The valuation of liabilities is also made on the basis of current salaries, as opposed to the projected salaries recommended by IAS 19. The German

accounting standards boards is currently discussing a new accounting standard (E-DRS 19) that follow similar principles to those of IAS 19.

21. One of the main fears of increased transparency and greater use of market valuations of pension liabilities is that they will lead to greater volatility in companies' balance sheets and hence to a retrenchment from pension plans provision. In the United Kingdom, there is little evidence showing a decline on pension coverage following the introduction of FRS17. Nonetheless, the introduction of FRS17 has coincided with a period in U.K pension provision in which new entrants to pension plans are offered only the option of a defined contribution formula.

22. An important issue to be determined is how IAS 19 will be applied in countries such as the Netherlands or Switzerland, where employer's liabilities are not clearly determined, since promises can be renegotiated (i.e. scaled back) and employee contributions increased. There are some who would even argue that occupational pension plans in the Netherlands are defined contribution from the employer's perspective and should therefore not be affected by IAS 19. The debate is still open on this issue.

23. What is clear is that if employer's liabilities are limited to specified contributions, then someone else must be bearing the investment and longevity risk of final salary, average salary and occupational plans with guaranteed returns. In the case of the Netherlands and Switzerland, it would appear that some of the risk is borne by the plan members. Dutch and Swiss pension funds, therefore, operate in a way that may be closer to that of mutual insurance companies than that of UK or US pension funds.